

## Internal Revenue Service

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June 24, 2008

### Legend

X =

A =

State =

D1 =

D2 =

D3

D4 =

a =

b =

c =

d =

e =

f =

g =

h =

Dear :

This letter responds to a letter dated February 15, 2008, written on behalf of X, requesting a ruling that rental income received by X is not passive investment income under § 1362(d)(3)(C)(i) of the Internal Revenue Code.

### Facts

X was incorporated under State law on D1, and elected under § 1362(a) to be an S corporation effective D4. X has accumulated earnings and profits and is engaged in the business of owning, leasing, and managing properties for commercial and industrial purposes. X owns a parcels of real estate, collectively referred to as Properties.

X has b employees, c of which are full-time, and d of which are part-time. X has a regular place of business and maintains normal office hours. X's employees perform a variety of management and tenant services on behalf of X, including the negotiation and execution of leases, administration of tax and insurance payments due on X's properties, billing and collection of rents from tenants, approval and supervision of tenant improvements, and oversight of maintenance and repairs of X's properties. X also provides ongoing maintenance and upkeep of its properties, including landscaping services, pest control, and cleaning of common areas.

In the fiscal year ending D2, X received \$e in gross rental income and paid \$f in operating expenses. In the short year ending D3, X received \$g in gross rental income and paid \$h in operating expenses.

### Law and Analysis

Except as provided in § 1362(g), § 1362(a)(1) provides that a small business corporation may elect, in accordance with the provisions of § 1362, to be an S corporation.

Section 1362(d)(3)(A)(i) provides that an election under § 1362(a) shall be terminated whenever the corporation (1) has accumulated earnings and profits at the close of each of three consecutive taxable years, and (2) has gross receipts for each of such taxable years more than 25 percent of which are passive investment income.

Section 1362(d)(3)(C)(i) provides that, except as otherwise provided in § 1362(d)(3)(C), the term "passive investment income" means gross receipts derived

from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities.

Section 1.1362-2(c)(5)(ii)(B)(1) of the Income Tax Regulations provides that “rents” means amounts received for the use of, or the right to use, property (whether real or personal) of the corporation.

Section 1.1362-2(c)(5)(ii)(B)(2) provides that “rents” does not include rents derived in the active trade or business of renting property. Rents received by a corporation are derived in the active trade or business of renting property only if, based on all the facts and circumstances, the corporation provides significant services or incurs substantial costs in the rental business. Generally, significant services are not rendered and substantial costs are not incurred in connection with net leases. Whether significant services are performed or substantial costs are incurred in the rental business is determined based upon all the facts and circumstances including, but not limited to, the number of persons employed to provide the services and the types and amounts of costs and expenses incurred (other than depreciation).

### Conclusion

Based on the facts submitted and representations made, we conclude that the rental income X receives from the rental of the Properties is not passive investment income under § 1362(d)(3)(C)(i).

Except as expressly provided herein, we express or imply no opinion concerning the federal tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Specifically, we express or imply no opinion regarding X’s eligibility to be an S corporation. Further, the passive investment income rules of § 1362 are independent of the passive activity rules of § 469; unless an exception under § 469 applies, the rental activity remains passive for purposes of § 469.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with a power of attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

/s/

Tara P. Volungis  
Senior Technician Reviewer, Branch 3  
Office of the Associate Chief Counsel  
(Passthroughs & Special Industries)

Enclosures (2):

Copy of this letter  
Copy for § 6110 purposes

cc: